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SUBJECT: New Legal Payments Framework: Monetary Integration  
at Retail Level

T-IA-F-05-016

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1. (SBU) Summary: The European Commission (EC) intends to propose a directive for payments services in the internal market by June or September. A legally consistent framework for the EU payments market, providing for transparency of payment services contracts, competition and consumer protection, is an essential building block for a Single European Payments Area (SEPA) in which banks handle all euro area payments as "domestic," essentially superceding purely national payments systems. The EC's goal is for citizens to be able to make payments around the euro area as simply and as easily as they make payments in their home national markets today, if not more so. This is monetary union integration at the retail level, the next big push that could help drive up efficiencies and competition to benefit EU consumers and industry.
2. (SBU) Realizing the vision is easier said than done. The EC has been laboring over a draft directive for several years and still faces considerable difficulties. The European banking industry, after being legislatively forced in 2001 to charge equally for domestic and cross-border payments, created the European Payments Council (EPC) to "get in front of the issue." The EPC has drawn up a roadmap on how banks would voluntarily cooperate to develop instruments, standards and infrastructure so national payments systems could migrate into a European one, creating a SEPA by 2010. Truth be told, only a small portion of the 56 billion or so annual payment transactions are cross-border. In other words, the business case for SEPA is not compelling for individual firms. The noble SEPA project has been slipping, despite the prodding of the European Central Bank (ECB).
3. (SBU) In a surprise move, Commissioner McCreevy has threatened to include industry standards and deadlines for the SEPA into the new legal framework directive. Member states will meet in mid-April to consider the idea. The EPC has responded with a resolution underlying its commitment, but the Commission is looking for firm assurances. Banks are content with the current profitable national payments systems, so they have little commercial incentive to change. EU policy officials, on the other hand, may want to accelerate the creation of a SEPA through legislation, hoping to reap its potential benefits sooner rather than later. End Summary

The Vision

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4. (SBU) Walk into a bank in Austria, make a transfer from your home bank in Germany to pay a contractor in Spain for work on your Costa del Sol villa. Or to pay for a car directly from the manufacturer in France. Done as quickly, easily and as inexpensively as you would make such a transfer for repairing your chalet in Kitzbeul or buying a car from a Vienna dealership. That is the vision for the euro area. Even though euros are legal tender throughout the euro area, cash is an expensive and inconvenient method of payment. A euro area payments system would increase competition in goods and services, increasing inefficiencies to benefit consumers and industry alike.
  5. (SBU) To realize this vision requires legal certainty and standardization of forms and processes. Legal certainty means that the users (customers) and providers of payment services (banks, card companies, money remitters) operate within the same legal framework of rights, obligations and transparency. Standardization means that banks use common instruments, standards and infrastructure for the execution of transfers among themselves on an inter-bank basis. The

EC's new legal framework for payment services would cover the first part; an initiative by the EPC would cover the latter, creating the SEPA.

#### Legal Framework for Payment Services

16. (SBU) The EC launched a consultation in December 2003 for a new legal framework directive. Its overall objective is to provide a consistent legal framework for a European payments market by providing a harmonized set of rules for all payment services. This would increase legal certainty and reduce compliance costs, allowing for economies of scale and cost and price reductions. The EC also wants to ensure a level playing field and enhance competition between payment service providers. Banks tend to be the larger players, but payments via direct debit cards, payment cards, money transmitters, and e-payments or m-payments are other important forms of payments. Allowing payment institutions authorized in one member state to be "passported" to operate throughout the EU would enhance competition, in the Commission's view. The EC also wants to have a consistent level of consumer protection and improved transparency.

17. (SBU) The EC's working draft contains general rules for payment service providers, requirements for being authorized as a payment institution, rules on payment services (transparency of conditions, provision and use of payment services, authorization of a payment service transaction, the execution of a payment transaction, fraud prevention, out-of court redress), and harmonization and mutual recognition among EU member states. The directive would establish a Payments Committee, composed of member state authorities competent for payment systems, to help ensure national implementation measures are harmonized and enter into force at the same time. The EC's work schedule indicates the proposal should be issued in June.

18. (SBU) Commentators generally share the EC's overall objective. The EC, however, has been having a difficult time committing to paper the legal obligations that would make it a reality - being consistent with the reality of how markets function and specific payments transactions take place. The European Payments Council, an organization of European banking associations, the Payments System Government Expert Group, and the Payment System Market Expert Group have provided the EC comments on its drafts. The fifth modified working draft was issued at the end of 2004 and still attracted much criticism. Two general criticisms have been that the drafts have changed substantially from one version to the next and have not reflected many of the views offered by industry.

#### Issues

19. (SBU) As the UK and Austria Presidencies will have the lead on directing the proposed payments services directive through the Council process, Finance Ministries and central bankers in those countries are tracking the key issues that have arisen in the drafting process. The following are some issues largely based on conversations with these experts and well as comments from some industry experts.

110. (SBU) Third Country Leg: The scope of the draft directive would apply to payment services where either the payer's payment service provider or the payee's payment service provider is located in the EU, unless stated otherwise. A payment service provider is a natural or legal person whose regular business includes the provision of payment services to payment service users. This means that if the customer making the payment in Greece, using a Greek bank for a payment to a person in the US, the payment service in the US would be subject to the directive. Or if a US person were to use its US bank to make a transfer to the Greek person, that payment service would also be covered.

111. (SBU) While the draft would restrict the application of obligations on fees and execution time to transactions within the EU, other obligations, such as on the availability of funds and liability for the execution of a payments transaction, could be read to apply to entities in third countries. Apart from the extraterritoriality issue, commentators have pointed out that EU payments providers should not be held liable for transactions outside the EU where such providers are subject to different rules. The EC's view is that the EU-based payment service provider's experience in dealing with entities in third countries should allow it to incorporate risks dealing with such entities in the provision and pricing of its services. The pricing of such risk is not a market price and would drive up costs and likely decrease service, in the view of some market experts.

112. (SBU) Second Party Transactions: Even without the third country leg, there is a question of the extent to which a payment service provider can be held accountable for an

entire transaction. German bankers' have pointed out that a payment service provider should be obliged by its contract for the use of its services (i.e. a customer directing it to make a payment a vendor with an account in another bank), but it cannot control or be held liable for the non-performance of another service provider (i.e. whether the vendor's bank will transfer the funds to the vendor's account). One US bank made a similar observation, noting that under the US Uniform Commercial Code, the originator's bank is not liable where there has been defective execution on the part of some intermediary banks or beneficiary banks.

13. (SBU) Competition: The directive would allow for the authorization of payment institutions, like Western Union and other providers of money remittances. Some member states, like Germany, require money remitters to be associated with a bank. UK officials take the view that such point-to-point remittances that do not extend credit hold very low risks and authorizes them as separate institutions. ECB officials have expressed concern about the prudential aspects of allowing payment institutions to operate on a "lighter regime," while banks are concerned that they will be at a competitive disadvantage and deprived of attracting customers to their local offices where they advertise and sell other consumer services. The EC is keen on opening up competition in this area to help drive down consumer costs.

14. (SBU) Liability: Several issues have arisen on liability. The draft directive would limit the loss to the payment service user resulting from the lost, stolen or misappropriate payment verification instrument to euro 150. Some commentators have accepted this level, others question why consumers should bear any loss, while others suggest that the consumer should bear more financial liability.

15. (SBU) A more problematic issue is that the recent working draft abolished the upper limit of euro 50,000 to which the provisions of the directive would apply, meaning it would apply to all transactions. This, coupled with the liability provisions on disputed transactions or unauthorized transactions would open payment service providers to potentially large risks, including increasing the risks of fraud committed by their clients, which would lead to reducing services. This would be particularly true in third country transactions mentioned above where the EU service provider would have a difficult time redressing potential abuses.

16. (SBU) Calling Back Transfers: The draft directive would accord the payer the right to refund a payment transaction which already has been executed under certain conditions, e.g. his authorization did not include the exact amount of the payment transaction at the time of its authorization or the amount of the executed transaction is contrary to the payer's "legitimate expectations," e.g. due to changes in exchange rate. The request for a refund needs to be made within six weeks of the payer being informed of the transaction and, in any case, before three months after the execution of the transaction. German bank commentators note that such a recall could be applicable to card transactions but not bank transfers. A major US card payment company, however, points out that some charges are not knowable in advance, such as car rentals that exceed the initial contract dates, a service offered to the consumer.

17. (SBU) Application to Card Transactions: The draft seeks to have uniformity for all payment services, but German bankers and a US card payment company point out that many of its provisions, including the very definition of a "payment transaction" (the "deposit, withdrawal, or transfer of funds from a payer to the benefit of a payee), applies to the payment transaction from the payer to the payee. However, the scope of the obligations would apply to payment services initiated by the payee at the authorization of the payee, e.g. card transactions (credit card services would not be covered by the directive). One solution would be to re-craft provisions for different types of payment services; another solution would be not to include card transactions in the directive.

18. (SBU) Waiver for Micro Payments: The working draft would permit member states to waive requirements for authorization and supervision of payments institutions where such institutions (a) have less than six million transactions a year and (b) hold a vital role in micro financial intermediation, such as for underprivileged social groups whose recourse to other payment services is limited; and the waiver is in the public interest for law and order and the effective implementation of money laundering rules. This waiver would be particularly useful for the UK and other member states that have large minority social groups that rely on informal money remittance systems.

19. (SBU) Corporate Carve Out: The draft directive would allow payment service providers and corporate users to agree

to different rules, so called service level agreements. As a UK expert pointed out, the directive would make little sense being applied between a multinational corporation and a global investment bank. Others suggest that small and medium-sized enterprises also have the leverage to strike deals with payment providers and the legal resources to make it stick, so they too should have the option not to apply the rules.

120. (SBU) Cash: The most recent draft unexpectedly had an expanded scope that included cash deposits and withdrawals. Industry experts observe that they have not had time to work through the implications of such a major change. Potential effects include delaying the deposits of cash, changing the way providers handle cash deposits (including out of hours and automated arrangements), and requiring supermarkets that provide "cash back" to be authorized as a payment institution.

#### SEPA: Roadmap and Reality

121. (SBU) Common standards for payment services would serve as the basis for inter-bank payments systems. In June 2002 the European Payments Council (EPC) was established to help put into place a Single European Payments Area (SEPA) by June 2010. Working backwards implies that by January 2008 citizens and commercial enterprises should be able to use pan-European instruments, services and standards for national payments. Initially this would mean that these pan-European activities would be in parallel with national ones. This would allow customers to make national and cross-border payments from one account. National instruments, services and standards would be gradually phased out, replaced by pan-European ones. National infrastructures would be abolished or transformed to a pan-European infrastructure.

122. (SBU) In December 2004 the ECB issued its third progress report towards a single European payments area in which it lamented that support for the "SEPA project and its objective had weakened." The ECB presented its expectations for the development of the necessary payments instruments, standards and infrastructure. It concluded that if banks were not able to get their acts together on a voluntary basis, then the ECB might adopt regulation. An Austrian central bank expert confirmed that, in his assessment, the project had slipped by two years.

123. (SBU) With respect to instruments, in November 2002 the EPC adopted the Credeuro Convention for cross-border straight through processing (STP). STP instructions include International Bank Account Number (IBAN), the beneficiary customer, and Bank Identifier Code (BIC) of the beneficiary's banks. Credeuro covers credit transfers of up to 12,500 euros, and guarantees a bank customer charges at the level of a domestic transfer and a maximum execution time of three days. In April 2003 the EPC adopted the Inter-bank Convention on Payments (ICP) to support Credeuro and harmonize inter-bank charging practices. Four countries (Germany, France, the Netherlands and Sweden) have transposed the ICP into national banking industry agreements. The ECB would like to see Credeuro and the supporting inter-bank charging convention become the compulsory minimum standard for all retail cross-border credit transfers by January 2006.

124. (SBU) To compete with national systems, by January 2008 the ECB wants to have same day value payments at the euro area level (called "Prieuro") and Credeuro as options for national credit transfers. Also by the same date the ECB wants to have pan-European direct debit (PEDD) as an optional standard available for all euro area customers' national direct debits. This would help ensure that PEDD would be used on a euro-wide basis by 2010.

125. (SBU) Uniform standards are essential to realize smooth straight through processing for payment transactions. For credit transfers the ECB suggests that the EPC implement a common account identifier (IBAN) for both national and cross-border credit transfers and direct debits in SEPA. The ECB also encouraged the EPC to define and implement standards for straight through processing, including a unique standard for electronic payment initiation and automated reconciliation.

126. (SBU) On infrastructure the EPC adopted a model for the European retail infrastructure, the pan-European automated clearing house (PEACH). The European Banking Association Clearing Company established the first and, to date, the only PEACH. The PEACH only handles transactions up to 12,500 euros, provides for 3-day execution time, and is limited to credit transfers. This is an expensive, narrower and slower system compared to national systems that realize lower costs through economies of scale, execute transactions in one day, and cover direct debits. The ECB wants national strategies for the migration of national infrastructure

systems to handle pan-European transfers. This could entail transforming efficient national systems into PEACH compliant systems or setting up completely new infrastructure.

#### Progress on SEPA: Public Policy Choices

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127. (SBU) The ECB's disappointment with the speed of banks' voluntarily working toward SEPA is understandable. The ECB holds the vision of an integrated euro market for retail payments as an important step for consumers and industry to reap more benefits of monetary union. Bankers' lack of drive is also understandable, since the SEPA requires a commitment of time and resources whose commercial pay-off is uncertain as long as efficient national payment systems exist. Cross border payments account for less than 5% of the 56 billion annual payment transactions. There are little economies of scale to be realized from such business.

128. (SBU) From a public policy perspective, the externalities of a SEPA appear to be large, promoting competition in goods and services on the European level to the benefit of consumers and industry. Individual banks may not find the business case for setting up cross-border payments systems, but together they could all benefit by have one payment system for the euro area rather than the present 25.

129. (SBU) According to UK officials these considerations motivated Commissioner McCreevy to get involved. In a March 10 speech McCreevy stated that banks need a "clear political signal," opining that he was convinced of "huge benefits" in making the investment for a SEPA, delivering "significant savings for banks, industry and consumers." Musing that "we cannot sit on our hands forever," McCreevy declared, "We will do what is needed to ensure that industry delivers a single payments area. If necessary, the Commission will make some agreed industry standards mandatory and include the roadmap for the SEPA in our draft legal text." One way that the Commission could spur faster action, in the view of UK experts, would be to require transactions be executed within one day - essentially the norm for domestic transactions.

130. (SBU) The Commission will meet with member state experts on April 12 to discuss how to proceed. If there is agreement to include SEPA issues in the proposed directive, the Commission is likely to delay launching the directive until September and would open up any new working draft to another round of public consultation. Meanwhile, the EPC has adopted a resolution that underscores its resolve to create the SEPA and has explained its work with banks on plans to migrate national systems to euro area systems. Whether this and other promises are enough to dissuade Commissioner McCreevy from proceeding with legislation on SEPA is a matter of on-going discussion.

#### Observations

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131. (SBU) SEPA is an important goal for the European Monetary Union and the EU internal market. Having a common payments framework is an essential block of the SEPA. However, including all forms of payments beyond just the banking payments that would be processed in SEPA, has complicated the EC's task. With such an ambitious undertaking, incorporating expert comments is important to get the draft legislation close to right the first time. After a few false starts, such as with the Prospectus Directive which needed to be totally re-written, the Commission has used informal consultation to good effect. That practice should continue in the new legal framework directive on payment services.

132. (SBU) As much as industry may resent being forced to act in an area it had promised action, experience suggests that such prodding may be necessary. In the run up to the introduction of the cash euro, survey after survey revealed how banks had charged significantly more for cross-border transfers than domestic ones. Time after time, banks promised to take action at the urging of the ECB, but failed to do so. Frustrated, on the eve of the introduction of the euro, Finance Ministers and the Parliament adopted a regulation requiring equal charges on cross-border transfers to those on domestic transfers. Despite cries of anguish, banks have complied. The EPC was created, in part, so banks wouldn't be forced to action again, allowing them to get ahead of the issue and help shape the debate. The EPC has gotten a wake up call.

133. (SBU) Keeping true to its own "impact assessment" approach to new regulations, the Commission should make a credible case for the externalities of proceeding with legislation for an SEPA. No doubt it could do so, but reports from those who have seen the impact assessment are not convinced. Avoiding being pre-empted by the ECB may



also motivate the Commission to adopt legislation. The ECB's threat of adopting regulations to spur the development of a SEPA is a direct challenge to the Commission's right of initiative for legislation. The ECB already crossed into the Commission's territory by elaborating standards on clearing and settlement. Proposing legislation would allow the Commission to control the issue and give a political signal that banks should get their act together.

134. (SBU) The mismatch between SEPA, applying to the euro area, and the draft proposed directive, applying to the EU, could raise the question whether the new framework is important for those countries that have not (or may not) adopt the euro in the foreseeable future. That is, why burden the market with standards on payment services if the market will not benefit from the efficiencies of the SEPA? The issue could be a real one as the UK will have the EU Presidency and be charged with steering the issue through the Council. UK officials, however, believe they have more to gain if they advance issues that are in the interest of the many even if they themselves might have other views. The UK will likely push the work program giving the Austrians a good basis to continue the Council's work next year.

135. (U) This message has been coordinated with US Embassies Berlin, London, and Vienna and USEU.

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